Examiner's report

P7 Advanced Audit and Assurance
June 2013

ACCA

General Comments

The performance of candidates in the June 2013 sitting was similar to the previous sittings. Performance overall continued to be unsatisfactory, though there were some excellent scripts and answers to certain requirements showed an improvement compared to similar requirements in previous exams. However performance on the whole has not improved.

The examination consisted of two sections, and candidates were required to answer four questions. Section A contained question 1 for 35 marks and question 2 for 25 marks, both of which were compulsory. Section B comprised three further questions of 20 marks each, only two of which should have been attempted.

The vast majority of candidates attempted the required number of questions, and there was little evidence of time pressure. Where question requirements were left unanswered by candidates, this appeared to be due to a lack of knowledge or poor exam technique, as opposed to time pressure.

In Section B, Question 3 was the most popular and Question 4 the least popular, though for the UK and IRL adapted papers Question 4 was chosen by a sizeable proportion of candidates and was often well attempted.

As in previous sessions, a significant minority of candidates answered the section B questions first, usually leaving Question 1 till last, and their answers to the Section A questions were often incomplete. As section A represents 60 of the available marks, leaving Questions 1 and 2 until last is a risky exam strategy, as many answers presented were incomplete or appeared rushed. This seemed to be a popular exam strategy for candidates attempting the Singapore (SGP) adapted paper.

A number of common issues arose in candidates' answers that contributed to the unsatisfactory pass rate:

- Failing to answer the actual question requirement and therefore providing irrelevant answers which scored few marks.
- Writing too little for the marks available.
- Identifying issues but not explaining, evaluating or assessing the issues as required.
- Lack of any real analytical or discursive skills.
- Illegible handwriting and inadequate presentation – this seems to be becoming more of an issue.
- Lack of audit knowledge – especially in relation to audit reports.
- Lack of basic accounting knowledge – there was a display of unsatisfactory understanding of double entry bookkeeping in many scripts.

The rest of this report looks at each question in turn, discussing candidates' performance on each requirement, highlighting those areas that were answered well, and those where there is room for improvement.

Specific Comments

Question One

This 35 mark question had two question requirements, and typically for Question 1, involved the planning stages of an audit engagement. The scenario was based on Parker Co, a new audit client, and information was provided in the form of extracts from financial statements, and notes from a meeting with the company's finance director. The notes covered matters including a brief business review, financing arrangements, internal control issues, and future plans for expansion.

As this style of question appears regularly it was no surprise that most candidates seemed well prepared for a question on audit planning, and there were some detailed and well-focussed answers. However there were some common problems seen in candidates' answers, which will be discussed below.

Requirement (a) was for 24 marks and asked candidates to perform analytical procedures and evaluate audit risks to be considered in planning the audit of Parker Co, and also to identify and explain additional information relevant to the evaluation. Looking first at the audit risk evaluation, this was generally reasonably well attempted, with most answers working through the information given in the scenario to identify and then discuss the audit risks. Almost all answers spotted the going concern risk facing Parker Co, and could evaluate it appropriately. The majority of answers also included commentary on the internal control weakness in payroll, and a discussion of several risks of material misstatement including classification and measurement of a provision, a revaluation of properties, and the classification of leases. Each of these had been clearly signposted in the scenario as issues related to audit planning.

Fewer candidates picked up on the less obvious audit risks. This was often because analytical review had not been conducted, or it had been done but then not used to help identify audit risks. One of the purposes of performing analytical review is to help the auditor to identify potential risks of material misstatement, and there were many audit risks that could have been identified in this scenario from properly prepared analytical review. For example the increase in inventory days indicates potentially obsolete inventory which may be overvalued and the deterioration in margins and interest cover add weight to the company's going concern problems. It is therefore important that when asked to perform analytical review that candidates do not just calculate trends and ratios but go on to assess them as part of the evaluation of audit risk. Calculating trends and ratios and then leaving them unused in the written part of the answer is poor exam technique and to some extent a waste of time.

Some candidates did no analytical review at all, which meant that as well as not picking up marks for relevant calculations, they also failed to achieve marks on identifying some audit risks. There were also many scripts that focussed exclusively on calculating trends rather than ratios, which often resulted in less detailed answers. A significant number of answers included incorrect calculations, with gearing ratios and return on capital employed being the most commonly mis-calculated.

The areas of audit risk that were generally well dealt with in this scenario included the following:

- Going concern – this was mentioned in almost every answer, and usually was quite well evaluated in some detail, with the majority of answers linking their analytical review to a discussion of the company's going concern problems. It was also pleasing to see that many candidates developed the risk into financial statement implications, particularly that going concern issues may need disclosure in a note to the financial statements.

- Provision for fine payable – most answers included a discussion relating to the measurement of the provision, which usually referred to the relevant financial reporting requirements. Whether the expense should be classified in cost of sales was also discussed in most answers.

- Development costs – this was usually very well evaluated, with almost all candidates appreciating that the development costs could include in error items of research expenditure that should not be capitalised, and that development costs may not meet the criteria for capitalisation due to Parker Co's lack of cash and the competitive nature of the market. Sound answers considered the impact on profit if the development costs had to be expensed.

- Property revaluations – the majority of candidates appreciated that the revaluations could have been done to improve the appearance of the statement of financial position, and many answers included a comment relating the auditor having to be sceptical when auditing the valuation of the properties.

- Finance costs – the relatively small increase in the finance cost compared to the increase in borrowings was often identified and well evaluated.

- Internal control deficiency – most answers included a section evaluating the deficiencies uncovered by the company's internal audit team, and its implication for audit risk.

- First year audit – this was identified as an issue in most answers, with the most common audit planning issue discussed being the lack of familiarity of the audit team with Parker Co, and that extra care would need to be taken when auditing opening balances. Sound answers also considered the appropriateness of accounting policies.

Some issues were less well evaluated:

- Trends and their implications – while most candidates could correctly calculate trends, for example the percentage decreases in revenue, cost of sales and operating expenses, many then went on to discuss the trends incorrectly, for example saying that the trend indicated a potential understatement of expenses when it should have been overstatement, or vice versa.

- Provisions – this was where even quite competent answers were often let down by an obvious lack of understanding of bookkeeping, with many answers stating that the provision should not be an expense at all, but should only impact on liabilities.

- Brand – many answers asserted that the company's brand was overvalued and should be tested for impairment. In fact there was no brand recognised in the financial statements at all, indicating that the extract from the financial statements had not been reviewed carefully enough.

- Change in accounting policy – many answers suggested that the property revaluation was a change in accounting policy, despite there being a revaluation reserve in the comparative figures.

- Taxation – few scripts picked up on the very low tax expense and tax liability, and even fewer calculated an effective tax rate which would have identified a significant risk of understatement.

Some of the problems noted above arise from lack of knowledge, others from poor exam technique. It is vital with this type of question to spend enough time reading the information provided, including the extracts from the financial statements, and to think about how the information gives rise to risk factors. It is obvious that when faced with an audit risk scenario, many candidates see a heading or word, for example "brand" and write an answer point that is totally irrelevant to the scenario.

As well as asking for analytical review and audit risk evaluation, this requirement also asked candidates for additional information that would help in the evaluation. Most answers contained at least a few requests for additional information, often those relating to the evaluation of going concern risk, such as cash flow forecasts and market research findings. It was pleasing to see in many scripts a wide range of information requests, and candidates are encouraged to read the model answer to this requirement in preparing for paper P7, to see examples of the kind of information requests included. Some answers however overlooked this part of the requirement, missing out on marks.

Other problems often seen in answers that scored less well on this requirement included the following:

- Long sections at the start of the answer describing the audit risk model in enormous depth
- Discussions of client acceptance matters such as the need for know your client procedures
- Detailed description of analytical procedure and its use in the audit (including at completion stage) with no application at all to the scenario
- Concentration on going concern risk and very little discussion of any other risk
- Repeating long sections of wording from the question requirement

Requirement (b) asked candidates to discuss any ethical issues raised and recommend actions to be taken by the audit firm. This was for 8 marks. Clearly many candidates were comfortable, producing satisfactory answers covering a range of ethical matters relevant to the audit firm. The ethical issues most commonly dealt with were conflict of interest, confidentiality and the self-review and advocacy threats, all associated with the planned acquisition by Parker Co of one of the audit firm's existing audit clients.

It was satisfactory to see that in general terms answers on ethics have improved somewhat compared to previous sittings in that they tend to discuss ethical threats rather than just identify them, and many answers used an appropriate framework to identify and explain threats, evaluate their significance, and recommend appropriate safeguards.

The ethical issues in respect of confidentiality and conflicts of interest were particularly well discussed, as was the self-review threat associated with providing a non-audit service to Parker Co.

However, there were still many answers, which often failed to recommend actions to be taken by the audit firm. Also, some answers tended to identify almost every possible threat without really explaining their relevance to the scenario. There also is an increasing trend for answers to consider ethical matters that have little, if anything, to do with the audit, and sometimes make little sense, for example whether it is "ethical" for Parker Co's management to develop a new organic product range, or whether the company's management "lacks integrity" for the company's going concern problems. Candidates are strongly advised to focus their answer on ethical threats directly related to the planning and performance of the audit.

Finally there were 4 professional marks available for Question 1, which were awarded for the structure of the answer, and for the clarity of explanations given and evaluation performed. Almost all candidates used a reasonable structure, with appropriate use of headings, and having an introduction. Fewer candidates provided a conclusion to their briefing notes. Though not essential, it is recommended that the calculations provided as part of analytical review are given in a separate section of the briefing notes, and then referred to in the main text, as this creates a well-structured answer. Again, not essential, but as part of exam technique candidates may want to consider having their requests for additional information as a separate part of the answer, presented in a clear list. Generally the presentation of answers was satisfactory, though as mentioned earlier in this report, a significant number of candidates have such illegible handwriting that it is very difficult to award many marks to the answer they have provided.

Comments specific to adapted papers:
For Question 1 there are some points worth making in relation to the performance of candidates attempting the adapted papers, as specific issues arose when marking these scripts.

SGP adapted paper – this had the same question requirements as the INT paper, so the answers produced by the SGP candidates should not have been markedly different to those written by INT candidates. However it was noticeable that many SGP candidates did not attempt Question 1 first, and often it was the last question attempted. The reason for this is not clear. The result however is that SGP candidates often performed less well on Question 1 than INT candidates, because their answers were simply too brief. The SGP answers generally, whether Question 1 was answered first or not, tended to have much less detailed discussion of audit risk factors and ethical threats.

UK and IRL adapted papers – these adapted papers had a slightly different Question 1. While the scenario was largely similar to the INT paper, the question requirements were more open ended, did not specifically refer to analytical review, and were not split into requirement (a) and (b). In addition there was more background and additional information provided to candidates. These adaptations were made to Question 1 in light of recommendations made by the regulator of the UK and Irish papers, and are not meant to make the question more difficult, but to allow for a greater range of answer points and flexibility in how the requirements are approached. The inclusion of the extra information also allows greater assessment of whether candidates can select the relevant information to be used in planning the audit.

On the whole, candidates coped well with the different style of the question, and while fewer answers included detailed analytical review, many did use the financial statements provided to calculate trends and ratios appropriately. Candidates are reminded that audit risk evaluation should include some analytical review, even if not specifically asked for. The additional information tended to be used appropriately, though some candidates did discuss matters that were not very relevant to evaluating audit risk, such as the planned development of e-commerce which did not impact on this year's audit.

UK and IRL candidates are strongly encouraged to read the part of the question containing the embedded requirements very carefully to ensure that all instructions are followed. A small number of answers for example failed to address the ethical matters arising in the scenario. As the marks are not allocated between the requirements, candidates will need to gauge how long to spend on each. This may seem daunting, but it can be seen as advantageous, as it means that marks are not capped for any one requirement.

A particular point noted when marking IRL answers was a tendency to produce extremely detailed answer plans for Question 1. While there was nothing wrong in creating a brief answer plan (in fact this is to be encouraged), in some cases the answer plan had obviously taken so long to write that it impacted on the quality of the actual answer to the question. Candidates are therefore encouraged to think carefully about how much of their time in the exam they should spend on writing out a very detailed answer plan which could be to the detriment of the answer itself.

Question Two

Question 2 was for 25 marks, and contained two separate requirements in relation to the same client, the Retriever Group. The first requirement was largely based around quality control and ethics, the second to do with a forensic investigation. The scenario provided was not long, and candidates did not appear to be time pressured when attempting this question.

Requirement (a) was for 13 marks. The scenario described various matters that had arisen during the performance of the audit as described one of the audit juniors, including time pressure, deviations from the audit plan, and the type of work that had been performed by the audit juniors, some of which was inappropriate. The requirement asked candidates to evaluate the quality control, ethical and other professional issues arising in the planning and performance of the audit. Answers on the whole were satisfactory, and candidates seemed comfortable with applying their knowledge of quality control requirements and ethical threats to the scenario. Most answers were well structured, working through each piece of information and discussing the matters in a relevant way. There were a number of scripts where the maximum marks were awarded for this requirement.

The common strengths seen in many answers included:

- Identifying that the audit had not been planned well, as it was time pressured and the allocation of tasks to audit juniors was not commensurate with their knowledge and experience.

- Discussing the problems in the direction and supervision of the audit, including the significant issue of the audit manager instructing the juniors not to follow planned audit procedures.

- Appreciating that review procedures were not being performed in accordance with ISA requirements, and that audit juniors did not know the limit of their responsibilities.

- Explaining the ethical threats caused by the audit junior's inappropriate work on deferred tax and tax planning.

- Describing the lack of competence and integrity of the audit manager in allowing the audit to be performed to such poor quality.

- Recommending that the audit team members receive training on quality control and ethical issues, and that the audit files should be subject to a detailed quality control review with a view to some areas of the audit possibly being re-performed.

It was especially encouraging to see that most candidates were not just able to identify the problems but could also explain and evaluate them to some extent.

There were satisfactory answers to this requirement, but some answers tended to simply describe the relevant ISA and ISQC requirements in relation to quality control with little application to the scenario. Some answers also tended to suggest that the audit team members should all be disciplined and / or reported to ACCA for "misconduct".

Requirement (b) was for 12 marks and contained a short scenario describing a burglary that had occurred at the Retriever Group. The Group's audit committee had asked the audit firm's forensic accounting department to provide a forensic accounting service to determine the amount to be claimed on the Group's insurance policy. The requirement asked candidates to identify and explain the matters to be considered and steps to be taken in planning the forensic investigation, and for the procedures to be performed. Unfortunately answers to this requirement were overall unsatisfactory indicating that this is not a well understood part of the syllabus.

Some answers tended to include one or more of the following in relation to the first part of the requirement:

- A lengthy discussion of what a forensic investigation is, including long definitions, with no application to the scenario – this was not asked for. This tended to be based on rote learning and earned few, if any marks.

- An assumption that management had already quantified the amount to be claimed, and that the forensic investigation would "audit" that amount – leading to mostly irrelevant answer points.

- A discussion about fraud and the lack of integrity of management for "allowing" the fraud to take place - this was often accompanied by lengthy speculation about the control deficiencies that failed to prevent the burglary from happening.

- A focus on whether adequate safeguards could be put in place to allow the audit firm's forensic accounting department to perform the investigation – this is a valid consideration to an extent, but the question did clearly state that there was no ethical threat.

- A discussion on the accounting treatment necessary for the stolen goods – again, not asked for.

In relation to the second part of the requirement, while some answers gave well described and relevant procedures to quantify the loss, many focussed exclusively on determining the volume of goods stolen and said nothing about the value of them. Many suggested discussing the amount to be claimed with the insurance provider and comparing our figure with theirs, clearly not understanding the point of the forensic investigation being to provide the amount to be claimed in the first place. On the plus side, most answers included suggestions that a reconciliation should be performed between the latest inventory count records and the amount of goods currently in the warehouse, though these were not often presented as procedures.

On the whole it was clear that many candidates were unprepared for a question requirement of this type, and that again it is apparent that a significant number of candidates rely on rote learnt knowledge and have difficulty to develop relevant answer points for a given scenario. Some candidates barely attempted this requirement, which for scripts achieving a mark that is a marginal fail is obviously a significant issue.

The UK and IRL adapted papers again had a slightly different style of Question 2. The content was broadly the same, though there was a little more additional and background information provided, and the requirements were embedded in the question requirement with the mark allocation not separated between them. This did not seem to have any significant impact on how candidates tackled the question.

Question Three

This question was in the style of a typical paper P7 question, set in the completion stage of an audit, and asking candidates to comment on the matters to be considered, and the audit evidence that should be expected to be found during the review of the audit files by the audit manager. Candidates were well prepared for this type of question, and as one of the optional questions, it was attempted by the majority of candidates.

Requirement (a) was for 8 marks, and described a number of properties that had been classified as held for sale. Information was given on the carrying value and fair value less cost to sell of the properties. Most answers were satisfactory, largely because candidates were confident in explaining the relevant financial reporting requirements and applying them to the brief scenario. The audit evidence points were sometimes a little vague, for example “discuss with management”, “get management representation”, “review board minutes”, and only a limited amount of credit could be awarded for such comments. However generally there has been an improvement in how well audit evidence is described, and in many cases the answer points were sufficiently precise and detailed.

Requirement (b) was for 7 marks, and described how a sale and leaseback arrangement had been accounted for. Answers to this requirement varied greatly in quality. Some were excellent, covering all of the financial reporting issues and correctly concluding that the treatment was wrong and if not corrected could have implications for the auditor’s opinion. In these cases, evidence points also tended to be adequate, focussing on the classification of the lease as a finance lease, and on the adjustment necessary in the financial statements. Inadequate answers discussed the points in a vague manner, seeming uncertain as to whether the accounting treatment was correct or not, resulting in the suggestion of a few unclear audit evidence points.

Requirement (c) was for 5 marks. This concerned a distribution licence that had been purchased and capitalised as an intangible asset and held at cost. Candidates seemed more comfortable with this requirement than the preceding one, and many discussed all of the relevant financial reporting concerns, particularly in relation to amortisation and / or impairment of the asset. Audit evidence points were usually provided and reasonably well explained.

Overall this was a well attempted question by many. I would however point out that candidates need to think carefully when calculating and commenting on materiality. Most candidates calculated the materiality of every figure given in the question in relation to each of revenue, profit before tax and assets. By this stage in their studies candidates should appreciate that often this is not necessary, for example there is little relevance in calculating an item of expense in relation to assets. Performing all of these calculations must take some time, and the irrelevant calculations will not generate marks.

This question was the same for INT and the adapted papers.

Question Four

This was the least popular of the section B questions, though for UK and IRL candidates this was less the case. The question was divided into separate requirements – requirement (a) was for 12 marks and concerned auditor liability, and requirement (b) for 8 marks, focussed on the audit of financial instruments.

Requirement (a) provided a scenario which described that an audit firm had given an unmodified audit opinion on Spaniel Co's financial statements, and that subsequent to the audit report being issued a fraud had been discovered that had been operating during the period covered by the audit report. The scenario also pointed out that the audit firm had not performed audit procedures in relation to the area in which the fraud was occurring, namely payroll. The requirement asked candidates to explain the matters to be considered in determining the audit firm's liability to Spaniel Co in respect of the fraud.

There were some excellent answers to this requirement. The best ones clearly outlined the factors that have to be proven to determine negligence, and applied them methodically to the scenario. The materiality of the fraud was considered, the duty of care owed to the audit client, and the fact that the auditor may not have been exercising professional scepticism during the audit due to the long-standing nature of the audit appointment. It was also appropriate to discuss the responsibilities of management and auditors in relation to fraud, and whether it is appropriate for auditors to rely on the conclusions reached in previous year's audit.

Some answers tended to only provide a rote-learnt description of responsibilities in relation to fraud, and usually failed to reach an appropriate conclusion. With little application to the scenario there is limited scope for marks to be awarded.

Requirement (b) described a different audit client, Bulldog Co, which had expanded overseas and set up a treasury management function dealing with forward exchange contracts. The requirement was to discuss why the audit of financial statements is challenging and explain the matters to be considered in planning the audit of the forward exchange contracts. Answers here were extremely mixed in quality. Satisfactory answers focused on why financial instruments generally are difficult to audit, discussing their complex nature, the changing landscape of financial reporting requirements, the potential for both client and auditor to lack appropriate knowledge and skills, and the frequent need to rely on an expert. In terms of planning the audit, adequate answers focussed on simple matters such as managing resources, obtaining an understanding of the nature of the contracts and the controls in relation to them, and assessing how management value the financial instruments.

Inadequate answers did not include much reference to audit at all, and simply listed out financial reporting rules, with no consideration of audit implications other than saying that financial instruments are complex and subjective.

There were very few references to relevant ISA requirements, and little evidence that the audit of complex matters such as financial instruments had been studied at all, even though it is a topical current issue.

Question Five

Many candidates chose to attempt Question 5, which focussed on audit completion and audit reports, despite clearly having very little knowledge and understanding of audit reports. Performance tended to be weak on this question overall.

The question was based in a Group audit scenario, in which three matters pertaining to the completion of the audit were described. The scenario made it clear that management was reluctant to adjust the consolidated financial statements in respect of the matters described.

Requirement (a) was for 7 marks and described the situation in relation to Toy Co, an overseas subsidiary of the Group, that was audited by local auditors and reported under the local financial reporting framework, not IFRS. The main issue was that under the local financial reporting rules a claim against the company would not result in the recognition of a provision, but under IFRS the provision should be recognised. The amount was correctly identified by almost all as material to the Group financial statements, and answers were generally satisfactory, despite the slightly complex scenario. Most candidates explained how an adjustment should be made at Group level and that if not made, the audit opinion should be qualified due to material misstatement. Some answers insisted, incorrectly, that the adjustment should be made in the subsidiary's individual financial statements. The fact that the audit evidence so far obtained was insufficient was not always identified, and only a minority of answers suggested the further audit procedures that should be conducted.. Some answers were confused about the impact on the opinion and suggested various options including adverse, disclaimer or in some cases, both.

Requirement (b) was also for 7 marks and provided a short description relating to a receivables balance outstanding in the parent company's financial statements for which payment was unlikely to be received due to the insolvency of the company owing the amount. Many candidates correctly identified this as an adjusting event after the reporting period, and determined that the amount was highly material. Some answers tended to focus on the going concern status of both companies, or suggested that the matter should be disclosed in both sets of financial statements but not adjusted for. Comments on the audit opinion were also mixed here, with many incorrectly stating that the issue should be highlighted in an emphasis of matter paragraph if not adjusted by Group management.

Before moving on to look at requirement (c) there are two other comments to make in relation to how candidates dealt with the audit report implications of requirements (a) and (b). The first point is that very few candidates considered the issues of (a) and (b) in aggregate. This was important because in aggregate the potential adjustments had a significant impact on Group results, and a discussion of whether this would result in an adverse opinion was relevant. Candidates are encouraged to always look at the bigger picture and even though the scenarios are described separately, they should at some point in the answer be considered collectively.

The second issue is that very few answers went beyond discussing the impact on the audit opinion. However the question asked for impact on the audit report, so marks were available for describing the structure and content of the basis of opinion paragraph as well as the opinion itself.

Turning to requirement (c), this was for 6 marks and briefly described how the chairman's statement to be published in the Group's annual report, contained a statement that the Group's revenue had increased by 20%. The vast majority of answers correctly determined that this was incorrect, revenue had actually increased by 5.9% and that this constituted a misstatement of fact. While there were some sound answers here from candidates who clearly understood the implications, unfortunately in many answers there was little else to be said, indicating a lack of knowledge of the auditor's responsibilities in relation to other information published with the financial statements, or the impact of such a misstatement on the auditor's report. Many answers suggested the use, incorrectly, of an emphasis of matter paragraph, but more suggested that there would be no impact at all on the auditor's report, and that the chairman's statement was nothing to do with the auditor's responsibilities.

Conclusion

In this exam sitting performance varied greatly, with the difference between a pass and a fail often being dependant on the level of application skills that had been displayed. Many candidates failed to achieve a pass because they relied too heavily on rote-learnt knowledge and failed to discuss facts in the context of the scenarios provided. This was not helped by gaps in knowledge – seen especially in relation to Question 2(b) and Question 5. Poor exam technique was also a factor, with most of those who did not pass the exam simply writing too few relevant points for the marks available. This does not mean that more writing equals more marks, in fact the opposite is sometimes true, however candidates must appreciate that writing a few sentences for a 8 mark requirement is not going to be enough. As always, the advice is to practice past questions and answers and review past examiner's reports to prepare for attempting this rigorous exam.